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Ending the Social Security Earnings Limit — for Everyone

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Last year Congress ended the Social Security earnings limit for seniors 65 years old and older. However, workers age 62 through 64 who decide to take early retirement are still penalized with an earnings limit tax. Since Congress and the Bush administration have both stated a desire to use the budget surplus to end or reform some of the most onerous taxes, such as the marriage tax penalty, they should consider eliminating the Social Security earnings limit for EVERY American.

The Social Security Earnings Limit

The Social Security earnings limit, or test, penalizes retirees who earn more income than a government-set figure by withholding a portion of their Social Security benefits.

The original earnings limit was created with the passage of Social Security in 1935 to fulfill social policy, not economic policy. Jobs were scarce during the Great Depression, and the earnings limit was intended to encourage retirees to leave the workforce so as to open up jobs for younger workers.

Over the years Congress liberalized the original earnings limit legislation. Initially it applied to all seniors. However, in 1950 Congress exempted retirees age 75 and older from the limit. That threshold was lowered to age 72 in 1954 and 70 in 1983. Thus seniors above those ages could earn any amount without the risk of losing any of their benefits that year.

In addition, the amount seniors could earn without losing benefits was increased over time. Initially the earnings limit offset was dollar-for-dollar: each dollar a retiree earned reduced his or her benefits by one dollar. In 1940 Congress changed its original policy by letting retirees earn up to $14.99 a month before the earnings limit kicked in. By the time it was eliminated in 2000 for seniors age 65 and over, they could earn up to $17,000 a year. For every $3 they earned above $17,000, seniors forfeited $1 in Social Security benefits. In other words, seniors age 65 and older faced a 33 percent marginal tax rate on every dollar they earned above $17,000. And, of course, like younger workers, they still faced standard income and payroll taxes.

The earnings limit also applies to "auxiliary beneficiaries": spouses or dependents whose Social Security benefits are dependent on another beneficiary. If a retiree's benefits are reduced by the earnings limit, benefits to their spouse or other dependent(s) are reduced as well.

The Earnings Limit Targets Only Earned Income

The earnings limit applies only to earned income, not to income from such sources as interest, rent and pensions. As a result, it disproportionately affects lower- and middle-income seniors, since most of their additional retirement income derives from working rather than pensions and assets accrued during their working lives.

Eliminating the Earnings Limit — for Some

By the spring of 2000 Congress and the administration had come to view the earnings limit as both unfair and counterproductive, at least for those 65 and older.

As President Clinton said when he signed the Senior Citizens Freedom to Work Act, which passed both the House and Senate by a unanimous vote: "Today, one in four Americans between 65 and 69 has at least a part-time job. Eighty percent of the baby boomers say they intend to keep working past age 65….Yet, because of the Social Security retirement earnings test, the system withholds benefits from over 800,000 older working Americans, and discourages countless more — no one knows how many — from actually seeking work…."[1]

Policymakers have always known that the earnings limit was a disincentive to work; that's why they included it in the original Social Security legislation. However, two factors have reduced support for the earnings limit. With unemployment at record low levels and employers scrambling to fill positions, it makes no social or economic sense to discourage seniors from working.

In addition, many seniors cannot live off their Social Security benefits, even if they also collect a small pension. They need or want to work and penalizing them for doing so, in effect, condemns them to poverty.

Congress was right to end such a policy. However, the task is incomplete.

Early Retirees Face Extreme Penalties

Early retirees age 62 through 64 still face a Social Security earnings limit.

In the early 1960s when Congress approved an early-retirement option for those aged 62 through 64, it also imposed an earnings limit on them. However, as if to discourage early retirement or at least discourage work after early retirement, Congress imposed an even more onerous earnings limit on early retirees.

Early retirees already settle for reduced benefits, and that reduction remains in effect for the rest of their lives. According to the Social Security Administration:[2]

- A hypothetical low-wage earner retiring at age 62 received $518 a month in 2000, compared to $598 for a senior retiring at age 65;
- An average earner retiring at age 62 received $853 a month in 2000, compared to $987 for a senior retiring at age 65;
- And high-wage earners received $1,110 retiring at age 62, versus $1,270 for some retiring at 65. [See Figure 1.]

If those early retirees decide to continue some form of work, their Social Security benefits will be reduced $1 for every $2 they make above the threshold — an effective 50 percent marginal tax rate.

For the year 2001, the threshold is $10,680 (it was $10,080 last year) — much less than the $17,000 those 65 and older faced before the earnings limit on them was eliminated. Yet, as late as 1977 the threshold for early retirees and those retiring at 65 was the same — $3,000.

Consider that under current law an early retiree working full time at only $6 an hour earns about $12,480 in a year — $1,800 above the limit. That means an early retiree loses $900 in Social Security benefits ($1,800/2 = $900) for being a responsible and productive member of society.

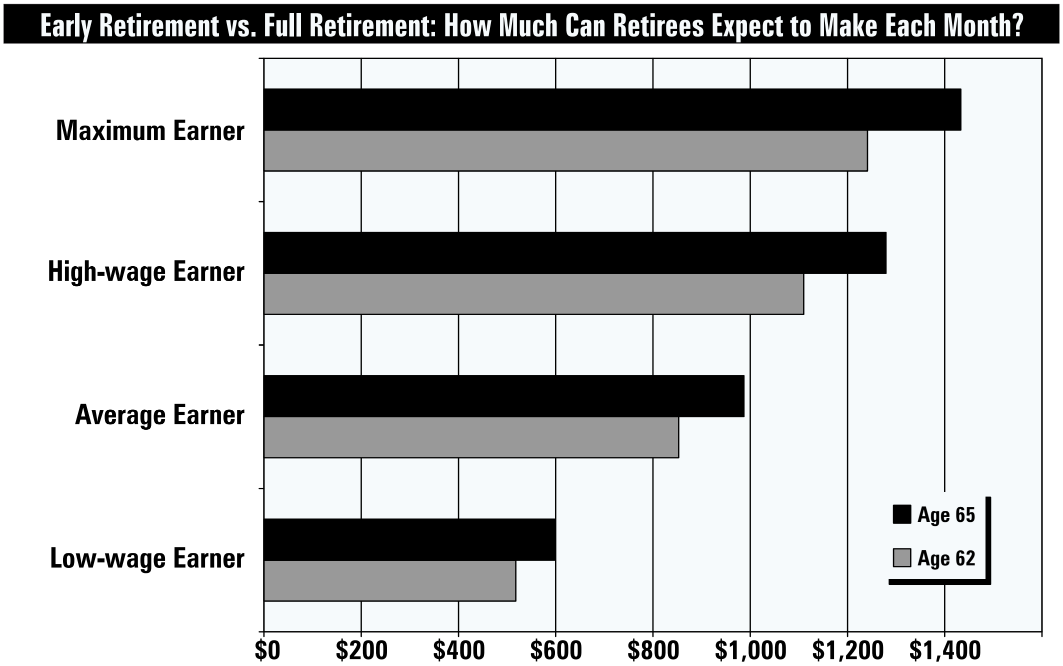


Figure 1
Early Retirement vs. Full Retirement:How Much Can Retirees Expect to Make Each Month?(2000)
Source: Social Security Administration

However, there are two caveats:

❶ The legislation repealing the earnings limit for those 65 and older also imposed the 33 percent marginal rate on early retirees in the year they retire. As a result, they pay a penalty of $1 for every $3 over the limit during the year they reach the federal retirement age — currently 65 and four months — whereupon they will no longer be subject to the penalty.

❷ Those who exceed the earnings limit and have to pay the penalty don't necessarily lose that money; it is "withheld" through the Delayed Retirement Credit (DRC) process, which is designed to reimburse those benefits gradually after they reach the full retirement age. Whether or not early retirees receive all of the money that was withheld depends on how long they live. Only if they live their full, actuarially expected lifespan will they be made whole.

The Retirement Age Is Rising

To make matters worse, beginning last year the retirement age for Social Security started to rise and will continue to rise slowly until it hits age 67 in 2022. Those retiring before the new threshold will be considered early retirees and thus a target for the earnings penalty. As a result, the age cohort forced to pay the tax will expand by two years — beginning at age 62 and extending through age 66 (for those born in 1955 or later).

That's a very important point. When Congress eliminated the earnings limit for seniors ages 65 through 69, many members probably thought they were removing this burden from seniors. However, the extension of the age threshold means that seniors ages 65 and 66 will once again face the earnings limit — *and at a 50 percent marginal rate rather than the 33 percent they had faced.*

Discouraging Productive Early Retirees?

The earnings limit on early retirees is a huge disincentive to work. According to the Social Security Administration, 581,000 early retires, ages 62 through 64, reported earnings in 1997, with about 496,000 reporting earnings of $10,000 or less (the earnings limit was $8,640 in 1997).[3] Thus about 85 percent of early retirees opted to keep their earned income close to or below the earnings limit. [See Table 1.]

Table 1
NUMBER OF RETIRED WORKERS WITH EARNINGS IN 1997

* Includes retired workers entitled to Social Security benefits as of December 31, 1996.

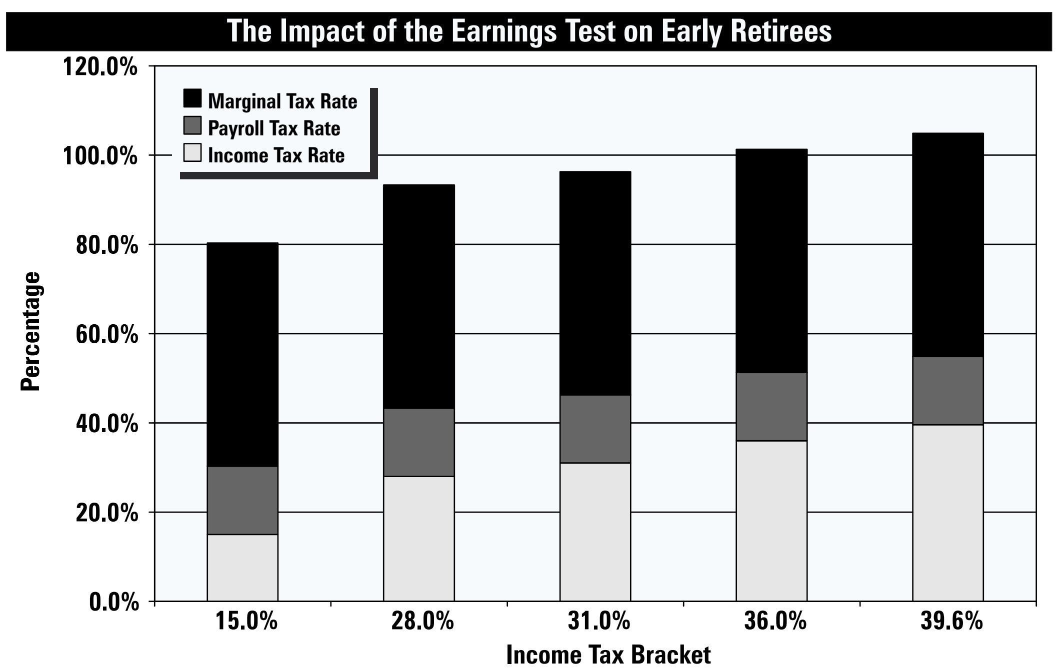
** Fewer than 300 workers.

Source: Office of Research, Evaluation and Statistics, Social Security Administration; 1997 1 Percent Continuous Work History Sample. Cited in the 2000 Green Book

NUMBER OF RETIRED WORKERS WITH EARNINGS IN 1997*

Total earnings	Ages 62–64	Ages 65–69
$1–4,999	289,600	915,400
5,000–9,999	206,700	507,200
10,000–14,999	43,100	338,800
15,000–19,999	17,100	107,800
20,000–24,999	6,700	63,900
25,000–29,999	5,400	45,400
30,000–34,999	3,200	34,400
35,000–39,999	2,300	25,800
40,000–44,999	1,300	19,800
45,000–49,999	700	17,000
50,000–54,999	900	14,200
55,000–59,999	400	11,100
60,000–64,999	900	9,700
65,000–69,999	400	7,300
70,000–74,999	500	6,900
75,000–79,999	200	6,300
80,000–84,999.	**	5,100
85,000–89,999	**	3,800
90,000–94,999	**	3,400
95,000–99,999	**	2,800
100,000+	1,400	35,900
Total	**581,200**	**2,182,000**

Figure 2
The Impact of the Earnings Test on Early Retirees' Marginal Tax Rate



When one considers the effective marginal tax rate these early retirees face, it's easy to see why they limit their work. As Figure II shows, according to their tax bracket, early retirees could easily lose more than a dollar for each dollar they earn above the $10,680 threshold.

- An early retiree in the 15 percent tax bracket would have to pay a 15.3 percent payroll tax in addition to the 50 percent earnings penalty, for a total marginal tax rate of 80.3 percent (not counting state and local income taxes).
- An early retiree in the 39.6 percent tax bracket, with a 15.3 percent payroll tax and a 50 percent earnings penalty, would face a total marginal tax rate of 104.9 percent (again, excluding state and local income taxes).

Would Early Retirees Work More?

How much more would early retirees work if the earnings limit were not in place? No one knows, but at least one economist's research provides some indication.

While eliminating the earnings limit for early retirees would certainly result in more of them working, estimating how many and how much has been difficult. Many early retirees value their time and have little desire or need to work. They may want to make a little additional income, but removing the earnings limit would not drive them to work more.

Economist Leon Friedberg of the University of California, San Diego, has analyzed this question. Looking specifically at men ages 65 through 69, he concluded that:[4]

- Low-income men would work 50 percent more, on average, if the earnings limit were eliminated;
- Middle-income earners would work about 18 percent more;
- And high-income workers likely would work about 4 percent less.

Many low-income workers are unable to live on their Social Security retirement checks, especially if the checks are discounted for early retirement. Removing the penalty would help them provide better for themselves and their families.[5]

Some middle-income workers would work more, but as a group they would be less likely to do so because removing the penalty would effectively raise their income, since they wouldn't be losing part of their benefits. By contrast, high-income workers would, on average, work less, since they no longer need to work as much to achieve what they regard as an acceptable level of income. Friedberg concluded his analysis by estimating that, "In total, men aged 65-69 who were earning at least up to the earnings limit in 1995 would be predicted to work 5 percent more."[6]

Friedberg's research focuses on men aged 65 through 69. What can be said about early retirees?

> The data show that some hold their earnings just below the limit, as do older workers, while a greater proportion continue to work full-time. Therefore, more workers at these ages might reduce their hours, relative to older workers, if the earnings test is eliminated. However, it is among this group that the "retirement effect" of the earnings test is crucial. If the earnings test causes some 62-64 year olds to retire, eliminating it would have an extra punch because they are likely to continue working longer than 65-69 year olds.[7]

Based on Friedberg's analysis, it may be fair to say that eliminating the earnings test on early retirees would help low-income early retirees most. They are the ones who most need the additional income and yet limit their work — therefore keeping their standard of living low — in order to avoid an onerous 50 percent effective tax rate.

Could Eliminating the Earnings Test Increase Poverty?

While almost all policy analysts supported eliminating the earnings test on those age 65 and above, some would oppose ending it on early retirees because they believe it could eventually increase the poverty rate among older seniors. Their reasoning goes like this:

Eliminating the earnings limit for early retirees might encourage more people to take early retirement, since they wouldn't be penalized for continuing to earn income. (Currently, 60 percent of workers already claim retirement benefits at age 62.[8])

However, it would also mean they would settle for a reduced monthly Social Security check for the rest of their lives. That reduced benefit might not be enough yearly income to lift them above the poverty level. While that might be fine while they could still work and supplement their income, at some point the additional earned income would likely cease, leaving them (primarily elderly widows) with only their reduced Social Security check.

While this concern is important, there are several points to consider.

Social Security Benefits Are Actuarially Balanced

The Social Security Administration has been trying to actuarially balance benefits so that a person living an average life span receives approximately the same amount of money whether he or she retires early, at the normal time or at age 70. Yes, early retirees' benefits are discounted, but they will get their checks over a longer period than does a person who retires at age 65. Similarly, 65-year-old seniors who delay retirement receive the Delayed Retirement Credit, which provides a 6 to 8 percent increase (according to when the person retires) for each year of delay, up to a maximum of five years (age 70). Thus, early and late retirees with similar earnings histories, on balance, receive the same amount of money regardless of when they retire.[9] In addition, as discussed earlier, early retirees who have their earnings withheld receive a Delayed Retirement Credit intended to return that money over time.

Thus, eliminating the earnings test may marginally disadvantage a small number of very old seniors — in 1998, 9 percent of the elderly were poor[10] — who have exhausted their other resources. However, other government programs — notably the federal Supplemental Security Income program or even changes to Social Security itself under upcoming reforms — are better suited to address this concern without penalizing early retirees.

Of course, policymakers know that many of those who officially fall below the poverty line might be financially comfortable, with assets that do not show up in government calculations. However, a slight increase in poverty among the elderly looks bad for politicians and federal policy. Thus, the biggest threat to ending the earnings limit may be political rather than economic.

The Earnings Limit Is the Real Threat to Increased Poverty.

The real threat to increased poverty may come from keeping the earnings limit in place. As mentioned above, some 85 percent of working early retirees keep their earned income around or below the earnings limit, and half keep it below $5,000.

Does it make sense to penalize early retirees, discouraging them from working and earning money that could pay off a house or car or be set aside in savings just to ensure that a few of them aren't considered poor at some future time?

How Much Will It Cost to End the Earnings Limit?

The Social Security Administration has estimated that repealing the earnings limit for seniors age 65 and older would cost about $23 billion over 10 years.[11] However, most actuaries agree that the long-term cost to the Social Security Trust Fund is zero because the benefits are actuarially balanced over recipients' lifetimes. While it will cost some money up-front, that early cost will eventually balance out.

Something similar could be said for ending the earnings limit on early retirees. It will cost Social Security some money initially because the program won't be allowed to withhold benefits of early retirees who continue to work. That's why ending it would affect the budget surplus for a few years after its elimination. But since the Social Security program eventually returns withheld benefits, there would be no long-term cost to the system.[12]

Indeed, ending the earnings limit would be a net gain for government coffers. Both early retirees and regular retirees who continue to work pay income and payroll taxes. And those payroll taxes do not count towards the size of their benefit checks, as they do for non-retired workers. Any payroll taxes paid by early retirees and seniors are a net increase for the Social Security Trust Fund.

Alternatives to the Early Retirement Earnings Limit

If Congress is concerned about elderly poverty, it should consider policies that would address that problem, not distort both the labor market and retirement decisions. For example, Congress could supplement the income of poor seniors.

Of course the real problem is that retirees, regardless of when they leave the workforce, receive a very low rate of return from their payroll taxes — currently about 2 percent. Were workers allowed to place part or all of those funds into private retirement accounts that could be invested in the market — probably through approved mutual fund managers — elderly poverty would virtually disappear. In addition, people could retire when they wanted without fear of losing their benefits because *they would own their retirement accounts*.

Conclusion

While it may have made sense to impose a Social Security earnings limit in 1935 when Congress created the program, it makes no sense today. Congress made the right decision in ending the earnings limit facing seniors ages 65 to 70. Now it's time to do the right thing for early retirees.

Endnotes

1 Quoted in Thomas P. Burke, "Social Security Earnings Limit Removed," *Compensation and Working Conditions Online*, Vol. 2, No. 5, Summer 2000.

2 "OASDI Program Benefit Amounts," Fast Facts and Figures about Social Security, Social Security Administration, Office of Policy, Office of Research, Evaluation and Statistics, August 2000, p. 16.

3 Green Book, House Committee on Ways and Means, 2000, Table 1-23.

4 Leon Friedberg, "Testimony before the Subcommittee on Social Security of the House Committee on Ways and Means," February 15, 2000.

5 The earnings penalty is not a tax, yet, as Friedberg says, "The perverse result is that people respond to the earnings test as if it were a tax, yet it raises virtually no revenue over the long run." Ibid.

6 Ibid.

7 Ibid.

8 Kenneth S. Apfel, "Testimony before the Subcommittee on Social Security of the House Committee on Ways and Means," February 15, 2000.

9 Ibid.

10 "Income of the Aged Population," Fast Facts and Figures about Social Security, p. 8.

11 Burke, "Social Security Earnings Limit Removed."

12 Ibid.

About the Author

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